REPORT DOCUMENTATION PAGE

Form Approved
OMB No. 0704-0188

1. REPORT DATE (DD-MM-YYYY) 14 December 2005	2. REPORT TYPE Article	3. DATES COVERED (From – To) Jan 2005-Jun 2005

4. TITLE AND SUBTITLE Distorted Risk Measures with Application to Military Capability Shortfalls	5a. CONTRACT NUMBER
	5b. GRANT NUMBER
	5c. PROGRAM ELEMENT NUMBER

6. AUTHOR(S) Edwin J. Offutt, Jeffrey P. Kharoufeh, Richard F. Deckro	5d. PROJECT NUMBER
	5e. TASK NUMBER
	5f. WORK UNIT NUMBER

7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Department of Operational Sciences Air Force Institute of Technology 2950 Hobson Way (AFIT/ENS) Wright Patterson AFB, OH 45433-7765	8. PERFORMING ORGANIZATOIN REPORT NUMBER Not Applicable

9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES) Not Applicable	10. SPONSOR/MONITOR'S ACRONYM(S)
	11. SPONSOR/MONITOR'S REPORT NUMBER(S)

12. DISTRIBUTION/AVAILABILITY STATEMENT

APPROVED FOR PUBLIC RELEASE; DISTRIBUTION UNLIMITED

13. SUPPLEMENTARY NOTES

14. ABSTRACT

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15. SUBJECT TERMS

Risk analysis, distortion functions, military capability

16. SECURITY CLASSIFCATION:			17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES	19a. NAME OF RESPONSIBLE PERSON Jeffrey P. Kharoufeh, Ph.D.
b. REPORT	b. ABSTRACT	c. THIS PAGE	UU	19	19b. TELEPHONE NUMBER (include area code) (937) 255-3636 x4603
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Standard Form 298 (Rev. 8-98) 298-102

Distorted Risk Measures with Application to Military Capability Shortfalls[1]

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December 15, 2005

Abstract

We consider the problem of selecting an appropriate distortion function and associated parameters to account for rare but catastrophic events that may result from a shortfall of military or security capabilities. Additionally, we describe the means by which a decision maker may allocate resources, subject to a finite budget constraint, while considering the impact of the risk of such shortfalls. The optimal decision is shown to be sensitive to the decision maker's level of risk aversion.

Keywords: Distortion function, risk measures, capability.

(Barchi Prize Nominee: Working Group 21)

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1   Introduction

In this paper, we review and illustrate the concept of distorted risk measures in order to analyze the risk of shortfalls in military capabilities. The application of these concepts leads to a method for optimally allocating resources among various military capabilities while taking into account the risk of shortfalls. However, an open and difficult question is the selection of appropriate distortion functions (and parameters), and their interpretations, for a given risk scenario. In this paper, it is our aim to elucidate the usefulness of these concepts, especially for scenarios involving low-likelihood, catastrophic events.

Consider a military or national-level decision maker who is faced with addressing shortfalls in military or homeland security capability. However, due to budgetary (or possibly other) constraints, only a subset of shortfalls can be addressed. We assume that input data from subject matter experts, in the form of risks of capability shortfalls, can be converted into appropriate risk distributions. While the decision maker may trust and value the opinions of the subject matter experts, he or she may desire to assign their own risk priorities in the resource allocation process to reflect additional information and/or considerations not necessarily available to the subject matter experts.

Distortion functions can be used to alter standard risk measures for scenarios in which the catastrophic occurrences in the tail of the risk distribution are of interest, but are often suppressed by standard risk measures (e.g., expectation and conditional expectation). In such cases, distortion functions serve the purpose of shifting probability density toward the region of the distribution that corresponds to highly adverse outcomes, thereby inflating the expectation risk measure. A wide variety of shaping effects and degrees of effect are possible depending on the distortion function selected and its parameters. The challenge for the decision maker is to select appropriate distortion functions to apply to the risk distributions suggested by his or her subordinates. Similarly, the selection of appropriate distortion parameters must also be considered, since the degree of distortion applied via the parameter selection can be (indirectly) linked to the decision maker's degree of risk aversion. While numerous distortion functions have been introduced in the literature (cf. [6] and [9]), there does not appear to be a formal methodology for the selection of a distortion function or its associated parameters.

As a relatively new and competing theory for the pricing of risk (prospect theory is the other), the properties of parametric distortion functions have been examined in the finance and insurance literature for the past ten years. The seminal work on distortion functions is due to Wang [8], who first proposed transforming the survivor function of the risk using the proportional hazard transform. Subsequently, Wang [9] generalized the theory of distortion to an entire class of functions used to calculate insurance premiums. Wang *et al.* [11] provided an axiomatic theory of insurance premiums pricing. Distortion and the axiomatic theory are tied to the concept of risk measure coherency, outlined by Artzner *et al.* [1] and further developed by the same authors in [2]. A coherent risk measure is one that accurately portrays the way financial markets operate. Artzner *et al.* [1] establish four attributes that a coherent risk measure must possess. McLeish and Reesor [6] proved that a concave distortion function produces a coherent risk measure. Wirch and Hardy [12] made two general observations regarding distortion parameters. First, they associate the parameters with a decision maker's risk aversion level toward risk in the far right tail of

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the distribution. Second, they state that the selection of distortion parameters is mostly a "political" decision. To our knowledge, the problem of selecting an appropriate distortion function and its parameter(s) has not been formally addressed in the risk analysis literature.

In this paper we seek to provide some guidance for the selection of distortion functions and their parameters when concerned with inflating the right tail of a risk distribution. We are motivated by the potentially catastrophic losses that may result from military or homeland security capability shortfalls. Specifically, this concerns the representation of catastrophic risks that cannot, for operational or political reasons, be disregarded despite their low likelihood of occurrence. Throughout this paper, we concern ourselves with the expected value of the risk; however, it is worth noting that we may choose any other coherent risk measure. (We discuss the meaning of a coherent risk measure in section 2.) Though it is admittedly difficult to generalize the guidelines to an arbitrary scenario, we attempt to provide a framework within which the risk of military capability shortfalls may be considered. For other contexts (e.g., insurance or financial risk), it may be necessary to develop a separate analysis.

We summarize and study the impact of three of the most widely referenced distortion functions on four frequently encountered parametric probability distributions, specifically the exponential, Weibull, triangular, and uniform distributions. Whenever possible, we provide analytical expressions for distorted risk measures. However, when analytical expressions may not be obtained, it is still possible to compute the measures by numerical methods. We propose two simple measures of distortion effects, and by means of a simple designed experiment, we argue that some distortions may be preferable to others, depending on the risk distribution and "amount" of distortion desired. Finally, we illustrate the means by which a decision maker's risk priorities may be incorporated into a resource allocation problem using appropriate distortion selection. The results of the paper offer some practical guidance for the application of distortion functions to some specific risk scenarios.

The remainder of this paper is organized as follows. In section 2, we define and review the concept of distorted risk measures and provide analytical results for the distorted expectation risk measure using a few common probability distributions. In section 3 we propose two distortion performance measures and provide a simple designed experiment to help establish some guidelines for distortion function selection. Section 4 describes a resource allocation problem which considers the decision maker's risk aversion levels, and section 5 provides a few concluding remarks and future research directions.

2 A Review of Distortion Functions

In this section, we provide a brief overview of distortion functions and coherent risk measures. Before presenting mathematical descriptions, we first provide an intuitive motivation for the use of distortions in a given risk scenario.

2.1 Concept of Distortion

Assume that risk is a nonnegative random variable. If one is concerned only about the probability that the random variable is above (or below) some critical value, and not about

what happens above that value, then it is instructive to simply use a quantile risk measure (i.e., the Value-at-Risk (VaR) measure in finance). In such a case, the distortion function is simply a step function and the resulting distorted risk measure has no probability in the tail of the original risk distribution. In many cases, however, the tail of the distribution is of interest since highly catastrophic losses can occur with low probability. In these scenarios, it makes sense to inflate the probability in the region of the original risk distribution that corresponds to highly adverse and unacceptable outcomes.

In our context, a military or national-level decision maker may forego the opportunity to acquire certain military capabilities. The risks involved in a shortfall of military capability can be viewed as the potential for loss of human life, loss of assets, or other significant losses. We assume that a nonnegative risk X is defined on an appropriate probability space $(\Omega, \mathcal{F}, P)$ with cumulative distribution function (c.d.f.) given by $F(x) = P(X \le x)$, $x \ge 0$ and survivor function $S(x) \equiv P(X > x)$, $x \ge 0$. The expectation risk measure is given by

$$E(X) = \int_0^\infty S(x)dx. \tag{1}$$

The problem of selecting the risk distribution for extreme events is a difficult question in its own right. We do not specifically address distribution selection here; however, some guidance is given by Lambert, *et al.* [5]. The objective of a distortion function is to transform the survivor function $S(x)$ so that when a risk measure is computed, the resulting distorted measure more adequately reflects the possibility and impact of extreme events. More formally, the distortion of S is given by the composition function

$$g(S(x)) \equiv (g \circ S)(x), \tag{2}$$

where g is a function satisfying (cf. [12]):

1. $g : [0, 1] \to [0, 1]$ is monotonically increasing;

2. $\lim_{u \downarrow 0} g(u) = 0$; and

3. $\lim_{u \uparrow 1} g(u) = 1$.

The function $\hat{S}(x) \equiv (g \circ S)(x)$ is again a survivor function with the usual properties: its range is $[0, 1]$, it is non-increasing in x, and integrating over the range of X gives the (distorted) expectation. That is, under the distortion g, the expectation risk measure is

$$\hat{E}(X) = \int_0^\infty \hat{S}(x)dx = \int_0^\infty (g \circ S)(x)dx. \tag{3}$$

The concept of distortion is closely tied to the concept of risk measure coherency which was formalized by Artzner *et al.* [2]. Suppose X and Y are two nonnegative random variables representing two risks and let ρ denote a risk measure. Then ρ is said to be a coherent risk measure if it satisfies the following four axioms:

1. Translation invariance: For all real α and r, $\rho(X + \alpha r) = \rho(X) - \alpha$

2. Sub-additivity: $\rho(X + Y) \le \rho(X) + \rho(Y)$

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3. Positive homogeneity: For all $\alpha \geq 0$, $\rho(\alpha X) = \alpha \rho(X)$

4. Monotonicity: If $X \leq Y$, then $\rho(X) \geq \rho(Y)$

McLeish and Reesor [6] have shown that, if g is a concave function, then the resulting distorted risk measure will satisfy the four axioms of coherency. This fact will be useful in determining appropriate distortion parameter values since we seek a resulting risk measure that is coherent. Next, we review some of the most commonly applied distortions.

2.2 Common Distortion Functions

The distortion functions most frequently encountered in the literature are the gamma-beta distortion and its variants which are discussed extensively in [6]. This family of distortion functions consists of the gamma-beta, beta, proportional hazard (PH), dual power (DP), gamma, and exponential (EX) distortions. Among these six, the single-parameter distortions (PH, DP, and EX) will be considered for three primary reasons: i) the effects of an individual parameter may be observed more easily; ii) the distorted expectation risk measure can be computed analytically in many cases, and numerically in others; and iii) it is desirable to minimize the number of parameters that need to be estimated.

The gamma-beta distortion is defined as

$$g_{GB}(S(x)) = \int_0^{S(x)} K t^{a-1} (1-t)^{b-1} \exp(-t/c) dt, \tag{4}$$

where

$$K^{-1} = \int_0^1 t^{a-1} (1-t)^{b-1} \exp(-t/c) dt.$$

This distortion serves as the basis for other distortions when we assume certain values for the parameters a, b, and c. It is worth mentioning here that a, b, and c may assume any nonnegative values; however, McLeish and Reesor [6] have shown that $0 \leq a \leq 1$, $b \geq 1$, and $c \geq 0$ are sufficient to ensure concavity of the distortion function, and thus coherency of the associated risk measure.

By setting $b = 1$ and allowing $c \to \infty$ in (4), we obtain the proportional hazard (PH) distortion given by

$$(g_{PH} \circ S)(x) = S^a(x), \quad 0 \leq a \leq 1. \tag{5}$$

The attractive feature of (5) is its ease of computation. By setting $a = 1$ and allowing $c \to \infty$ in (4), we arrive at the dual power (DP) distortion given by

$$(g_{DP} \circ S)(x) = 1 - (1 - S(x))^b, \quad b \geq 1. \tag{6}$$

As noted by Wirch and Hardy [12], this distortion has perhaps the most lucid interpretation. For an integer value of b, the expectation risk measure corresponds to the expected value of the maximum of a sample of b observations of X. Finally, the exponential (EX) distortion depends only on the single parameter c and is given by

$$(g_{EX} \circ S)(x) = \frac{1 - e^{-S(x)/c}}{1 - e^{-1/c}}, \quad c \geq 0. \tag{7}$$

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This distortion corresponds to an exponential random variable restricted to the interval $[0, 1]$.

The question with which we concern ourselves in this paper is, "Why may one of the distortion functions be preferable to the others in a given context?" The answer to this question is that it depends upon the risk scenario under consideration. In Figure 1, each of the single-parameter distortions is applied to an exponentially distributed risk X with rate parameter $\lambda = 3.5$. The gamma-beta distortion is also included since it uses all three parameters a, b, and c. The undistorted exponential density is depicted by the solid line. Among the single-parameter distortions, the proportional hazard (PH) distortion has the greatest effect on the right tail of the distribution, thickening it considerably. The dual power (DP) distortion, while inflating the right tail slightly, has a much more noticeable effect on the left side of the distribution, shifting the mode away from zero. The exponential (EX) distortion can best be described as a combination of the effects of the PH and DP. In general, these effects are consistent for the other distributions considered in this paper.
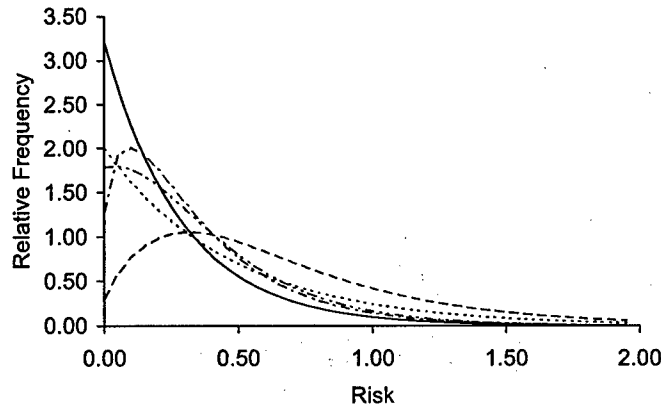

Figure 1: Distorted density when $X \sim \text{Exp}(3.5)$ with distortion parameters $a = 0.6$, $b = 1.5$, and $c = 0.8$ for GB (solid is no distortion, $- - -$ GB, $\cdots$ PH, $- \cdot - \cdot$ DP, $- \cdot \cdot -$ EX) .

From this plot, we can clearly observe why a particular distortion function might be preferred over another. One may be more concerned with inflating the right tail rather than altering the left-hand side of the distribution. In what follows, we compute the distorted expectation risk measure using the three single-parameter distortion functions and four common, parametric probability distributions. These will be used to study the effects of distortions and their parameters in section 3.

2.3   Computing Distorted Measures

In order to elucidate the effects of distortion, we now apply the single-parameter distortions to a set of parametric probability distributions. The four distributions we consider are: 1) exponential with rate parameter λ (denoted $\text{Exp}(\lambda)$); 2) Weibull with shape parameter β and scale parameter θ (denoted $\text{Weib}(\beta, \theta)$); 3) triangular on the closed interval $[\theta_1, \theta_2]$ with mode m (denoted $\text{Tria}(\theta_1, \theta_2, m)$); and 4) continuous uniform on the closed interval

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$[\theta_1, \theta_2]$ (denoted $U(\theta_1, \theta_2)$). We select these four distributions because they are representative of risk distributions from a variety of disciplines including actuarial science, financial and insurance risk, as well as reliability. Moreover, they span a range of distribution shapes on both bounded and unbounded intervals. Finally, they have a relatively small number of parameters that may be easily estimated using information that is likely to be available from subject matter experts.

For each combination of distribution and distortion, we have attempted to summarize analytical expressions for the distorted expectation risk measure given by equation (3). In some cases, explicit expressions are attainable, while others remain as integral expressions that may be evaluated numerically using standard methods. These results are recorded in Tables 1 through 4.

First suppose the risk X is exponentially distributed with rate parameter $\lambda > 0$. In such case, the survivor function is given by

$$S(x) = \begin{cases} e^{-\lambda x} & \text{if } x \geq 0, \lambda > 0 \\ 0 & \text{otherwise} \end{cases} \tag{8}$$

The undistorted risk measure is $\mu_0 \equiv E(X) = \lambda^{-1}$. Table 1 provides a summary of the distorted survivor function and the distorted risk measure computed by equation (3).

Table 1: Distorted risk measures when $X \sim \text{Exp}(\lambda)$.

Distortion function	$\hat{S}(x)$	$\hat{E}[X]$
g_{PH}	$e^{-\lambda a x}$	$(\lambda a)^{-1}$
g_{DP}	$1 - (1 - e^{-\lambda x})^b$	$\int_0^\infty [1 - (1 - e^{-\lambda x})^b]\, dx$
g_{EX}	$\frac{1 - \exp(-e^{-\lambda x}/c)}{1 - \exp(-1/c)}$	$\int_0^\infty \frac{1 - \exp(-e^{-\lambda x}/c)}{1 - \exp(-1/c)}\, dx$

Next, suppose the risk follows a Weibull distribution with parameters β and θ. In such case, the survivor function is

$$S(x) = \begin{cases} \exp((-x/\theta)^\beta) & \text{if } x \geq 0, \beta > 0, \theta > 0 \\ 0 & \text{otherwise} \end{cases}, \tag{9}$$

and the undistorted expectation is $\mu_0 = (\theta/\beta)\Gamma(\beta^{-1})$, where $\Gamma(\cdot)$ is the gamma function. Similarly, the distorted risk measures are summarized in Table 2.

Table 2: Distorted risk measures when $X \sim \text{Weib}(\beta, \theta)$.

Distortion function	$\hat{S}(x)$	$\hat{E}[X]$
g_{PH}	$e^{a(-x/\theta)^\beta}$	$\frac{\theta}{\beta \sqrt[\beta]{a}} \Gamma\left(\frac{1}{\beta}\right)$
g_{DP}	$1 - (1 - e^{(-x/\theta)^\beta})^b$	$\int_0^\infty [1 - (1 - e^{(-x/\theta)^\beta})^b]\, dx$
g_{EX}	$\frac{1 - \exp(-e^{(-x/\theta)^\beta}/c)}{1 - \exp(-1/c)}$	$\int_0^\infty \frac{1 - \exp(-e^{(-x/\theta)^\beta}/c)}{1 - \exp(-1/c)}\, dx$

The third distribution we considered was the triangular distribution on $[\theta_1, \theta_2]$ with mode value m. The survivor function is given by

$$
S(x) = \begin{cases}
1 & \text{if } x < \theta_1 \\
1 - \frac{(x - \theta_1)^2}{(\theta_2 - \theta_1)(m - \theta_1)} & \text{if } \theta_1 \le x \le m \\
\frac{(\theta_2 - x)^2}{(\theta_2 - \theta_1)(\theta_2 - m)} & \text{if } m < x \le \theta_2 \\
0 & \text{if } x > \theta_2
\end{cases}, \tag{10}
$$

where $\theta_1 < \theta_2$, $\theta_1 \le x \le \theta_2$, and $\theta_1 \le m \le \theta_2$. The undistorted expectation is $\mu_0 = (\theta_1 + \theta_2 + m)/3$.

Table 3: Distorted risk measures when $X \sim \text{Tria}(\theta_1, \theta_2, m)$.

Distortion function	$\hat{S}(x)$	$\hat{E}[X]$
g_{PH}	$\left(1 - \frac{(x-\theta_1)^2}{(\theta_2-\theta_1)(m-\theta_1)}\right)^a$, $\theta_1 \le x \le m$ $\left(\frac{(\theta_2-x)^2}{(\theta_2-\theta_1)(\theta_2-m)}\right)^a$, $m < x \le \theta_2$	$\int_{\theta_1}^{m} \left(1 - \frac{(x-\theta_1)^2}{(\theta_2-\theta_1)(m-\theta_1)}\right)^a dx$ $+ \frac{(\theta_2-m)^{a+1}}{(2a+1)(\theta_2-\theta_1)^a}$
g_{DP}	$1 - \left(\frac{(x-\theta_1)^2}{(\theta_2-\theta_1)(m-\theta_1)}\right)^b$, $\theta_1 \le x \le m$ $1 - \left(1 - \frac{(\theta_2-x)^2}{(\theta_2-\theta_1)(\theta_2-m)}\right)^b$, $m < x \le \theta_2$	$m - \theta_1 - \frac{(m-\theta_1)^{b+1}}{(\theta_2-\theta_1)^b(2b+1)} +$ $\int_{m}^{\theta_2}\left[1 - \left(1 - \frac{(\theta_2-x)^2}{(\theta_2-\theta_1)(\theta_2-m)}\right)^b\right]dx$
g_{EX}	$\frac{1-\exp\left(\frac{-1}{c} + \frac{(x-\theta_1)^2}{c(\theta_2-\theta_1)(m-\theta_1)}\right)}{1-\exp(-1/c)}$, $\theta_1 \le x \le m$ $\frac{1-\exp\left(\frac{-(\theta_2-x)^2}{c(\theta_2-\theta_1)(\theta_2-m)}\right)}{1-\exp(-1/c)}$, $m < x \le \theta_2$	$\int_{\theta_1}^{m} \frac{1-\exp\left(\frac{-1}{c} + \frac{(x-\theta_1)^2}{c(\theta_2-\theta_1)(m-\theta_1)}\right)}{1-\exp(-1/c)} dx$ $+ \int_{m}^{\theta_2} \frac{1-\exp\left(\frac{-(\theta_2-x)^2}{c(\theta_2-\theta_1)(\theta_2-m)}\right)}{1-\exp(-1/c)} dx$

Finally, when the risk X is distributed $U(\theta_1, \theta_2)$, the survivor function is given by

$$S(x) = \begin{cases} 1 - \frac{x-\theta_1}{\theta_2-\theta_1} & \text{if } \theta_1 \le x \le \theta_2 \\ 0 & \text{otherwise} \end{cases}, \tag{11}$$

and the undistorted expectation is $\mu_0 = (\theta_1 + \theta_2)/2$. Table 4 summarizes the distorted survivor function and risk measure.

Table 4: Distorted risk measures when $X \sim U(\theta_1, \theta_2)$.

Distortion function	$\hat{S}(x)$	$\hat{E}[X]$
g_{PH}	$\left(1 - \frac{x-\theta_1}{\theta_2-\theta_1}\right)^a$	$(\theta_2 - \theta_1)\left(\frac{1}{a+1}\right)$
g_{DP}	$1 - \left(\frac{x-\theta_1}{\theta_2-\theta_1}\right)^b$	$(\theta_2 - \theta_1)\left(\frac{b}{b+1}\right)$
g_{EX}	$\frac{1-\exp(-(1-\frac{x-\theta_1}{\theta_2-\theta_1})/c)}{1-\exp(-1/c)}$	$(\theta_2 - \theta_1)\left(\frac{1-c+ce^{-1/c}}{1-e^{-1/c}}\right)$

It is important to note that, for the intractable results in Tables 1-3, the distorted risk measure may be approximated using standard numerical quadrature routines widely available in standard computing environments. In section 3, we propose measures that may be used to assess the effect of distortion and present a designed experiment to assist in establishing guidelines for appropriate distortion function selection.

3   Measuring Distortion Effects

In this section, we propose measures of effectiveness and efficiency to assist in selecting distortion functions and their associated parameters. But first we introduce a measure of the magnitude of probability density displacement that results from the application of a distortion function. This measure of density translation uses the median of the risk distribution, namely that point at which the undistorted distribution is partitioned with equal density on either side. After distorting the original risk distribution, the magnitude of density translated from the left of the undistorted median to the right of the median is computed via the measure

$$R_g \equiv \frac{(g \circ S)(\psi)}{S(\psi)}, \tag{12}$$

where $\psi \equiv \inf\{x > 0 : S(x) = 0.5\}$ denotes the median of the undistorted risk distribution, S is the undistorted survivor function, and $(g \circ S)$ is the distorted survivor function. Since the distortion functions used in this research all shift density to the right, we see that

$$1 \leq R_g \leq 2,$$

since by this ratio measurement all of the density to the left of the median can theoretically be shifted to the right of the median. However, R_g does not measure how "far" this density

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has been shifted – it only reflects the fact that it has been translated beyond the undistorted median. Conversely, if $R_g = 1$, this implies that no distortion is applied whatsoever.

3.1 Effectiveness and Efficiency

The primary risk measure considered in this work is the expectation of the risk random variable. Recall that expectation has a drawback in that low-frequency risk values tend to be "dampened out" by the values with the greatest relative frequency. However, distortion functions can provide the decision maker with the ability to control expectation to predictable degrees. In choosing a distortion function for a specified risk distribution, the decision maker would like to know how *effective* each candidate distortion function/parameter combination is in inflating the expectation risk measure. After applying a distortion g and computing the distorted expectation $\mu_g \equiv \hat{E}(X)$, the measures can be compared to determine which distortion has the greatest effect on that risk distribution's mean. To develop the idea further, we define the following measure.

Definition 1 *The effectiveness of a distortion function is defined as the ratio,*

$$K = \mu_g/\mu_0 \tag{13}$$

where μ_g is the distorted risk measure obtained by applying distortion g and μ_0 is the undistorted risk measure.

This ratio can, for example, be used to directly compare a unique distortion function/parameter pairing over different distributions, measuring that pairing's effectiveness in changing each distribution's expectation as a percentage increase. It is obvious that $K \geq 1$, and whenever $K = 1$, no distortion has been applied. Similarly, two different distortion function/parameter combinations applied to two dissimilar risk distributions having equal K-values are deemed to be equally effective in distorting (increasing) the expectation risk measure.

Through numerical experimentation, we have observed clear contrasts in the way different distortion function/parameter pairs shift density. As applied to a single risk distribution, one combination may require significant density shift before its K-value matches that of another pairing which has a greater effect on the distribution's tail. Prototypical examples are the PH and DP distortions. The PH distortion accumulates density in the right tail while the DP accumulates it closer to the mode, so the PH generally has a greater effect on expectation. A measure to reflect the magnitude of density shift has already been established, namely R_g. For this reason, it seems beneficial to combine the two measures K and R_g into a single measure of *efficiency*.

Definition 2 *The efficiency of a distortion function g is defined as the ratio of the normalized change in the risk measure to the normalized change in density given by*

$$E = K/R_g. \tag{14}$$

The measure E should not be confused with the concept of statistical efficiency related to parameter estimation. Intuitively, if a distortion function/parameter combination has a large

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effect on the expectation risk measure while shifting a relatively small magnitude of density, then that pairing is highly efficient when applied to the given distribution.

One might ask, "Why would a decision maker care about the amount of density being shifted? Why isn't the effectiveness of the distortion function/parameter combination all he or she needs to know in making a selection?" Note that without the efficiency measure, there would be no need to distinguish between two pairings with identical effectiveness; the decision maker would feel that one is just as good as the other, even though the underlying distribution is being changed in an entirely different manner depending on the choice. As an example, consider Figure 2, which shows an undistorted Weib(2,2) distribution along with its PH ($a = 0.2$) and DP ($b = 31$) distortions. Both of the distorted distributions have $K \approx 2.24$, but the densities are hardly similar.
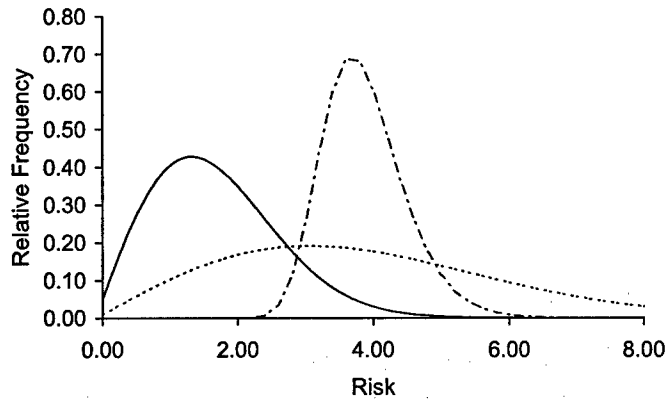

Figure 2: Distorted densities when $X \sim$Weib(2,2) with distortion parameters $a = 0.2$ and $b = 31$ (solid is no distortion, $\cdots$ PH, $- \cdot -\cdot$ DP).

Furthermore, the decision maker should care a great deal about how much density is being shifted to achieve a desired increase in the resulting risk measure. More specifically, the decision maker has solicited risk distributions from subject matters experts who presumably possess expertise the decision maker is lacking. For every unit increase of the measure R_g, the decision maker is taking an additional "step" away from the recommendations of his or her advisors. To illustrate this point, consider again Figure 2 in which the distortions have altered the original Weibull risk distribution into two radically different ones. Thus it seems likely that the decision maker would prefer one of two possible courses of action in choosing a distortion function/parameter combination:

1. achieve the maximum amount of increase in the expectation while affecting the original risk distribution by (no more than) a specified amount (say 20%); or

2. achieve a specified increase in expectation, but affect the original risk distribution as little as possible.

In either case, efficiency is the measure which provides the appropriate answer.

In order to investigate the impact of the distortion parameters on these measures, we carried out a 3^k-factorial designed experiment. For this purpose, we arbitrarily selected the

following distribution parameters for each of the four distributions noted earlier: Exp(3.5), Weib(2,2), Tria(1,7,4), and $U(1,7)$. The factorial design was used to study the effects of each parameter (a, b, and c) in the gamma-beta distortion, and within this factorial design, each of the involved parameters was required to have relatively equal power over the R_g measure so that the interaction effects could be analyzed in a "fair" manner. Since we chose a face-centered cube design, three equally-spaced values were used for each parameter. Table 5 summarizes the selected distortion parameter values (or treatments). Recall that when $a = 1$, $b = 1$, and $c \to \infty$, no distortion is applied. We note that distortion is inversely proportional to the parameters a and c while it is proportional to the parameter b.

Table 5: Selected distortion parameter treatments.

Distortion (Parameter)	Selected Values		R_g (% density shift)
	High	0.90	1.07 (7%)
Proportional Hazard (a)	Mid	0.75	1.19 (19%)
	Low	0.60	1.32 (32%)
	Low	1.10	1.07 (7%)
Dual Power (b)	Mid	1.30	1.19 (19%)
	High	1.50	1.29 (29%)
	High	3.60	1.07 (7%)
Exponential (c)	Mid	2.20	1.11 (11%)
	Low	0.80	1.30 (30%)

Table 6 records the efficiency and effectiveness measures for the risk distributions and single-parameter distortions studied in this paper. In general, as the amount of distortion is increased the efficiency is decreased. There are three exceptions to the general rule, however, and the efficiency measures for these three cases are highlighted in bold face type. Specifically, in the case of the exponential distribution, an increase in distortion results in an increase in efficiency when using the PH and EX distortions. For the PH distortion applied to the Weibull distribution, efficiency at first decreases as distortion is increased, then changes course and begins to increase again; a brief investigation to verify this result showed that the least efficiency occurs at about $a = 0.72$.

Using Table 6, some general rules (within the limits of this study) can be established for selecting a distortion function to apply to a distribution. Recall that a decision maker would likely be interested in either (i) achieving the largest possible increase in the mean given a specified maximum shift in density, or (ii) shifting the density by the smallest amount required to achieve a specified increase in mean. Using Table 6, some answers may be available when objective (i) is of primary importance. Table 7 was created from Table 6 by comparing efficiency across categorized values of R_g. For example, looking at the triangular distribution in Table 6, the low-distortion efficiency values are 0.9602 for the PH ($a = 0.9$), 0.9614 for the DP ($b = 1.1$), and 0.9579 for the EX ($c = 3.6$). Since the DP value is the highest, this was entered into the appropriate cell of Table 7. Thus in the case of objective (i) when assuming a triangular risk distribution, the DP distortion is the most efficient (although the values are relatively close in this case).

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Table 6: Effectiveness and efficiency measures for all distortion/distribution pairings.

Distortion →	PH			DP			EX		
Measure ↓	$a = 0.9$	$a = 0.75$	$a = 0.6$	$b = 1.1$	$b = 1.3$	$b = 1.5$	$c = 3.6$	$c = 2.2$	$c = 0.8$
Exp(3.5), $\mu_0 = 0.285714$									
μ_g	0.3175	0.3810	0.4762	0.3036	0.3363	0.3658	0.3058	0.3189	0.3791
R_g	1.0718	1.1892	1.3193	1.0670	1.1877	1.2929	1.0693	1.1131	1.3027
K	1.1111	1.3333	1.6667	1.0625	1.1772	1.2803	1.0704	1.1161	1.3270
K/R_g	**1.0367**	**1.1212**	**1.2633**	0.9958	0.9911	0.9903	**1.0010**	**1.0027**	**1.0186**
Weib(2,2), $\mu_0 = 1.772454$									
μ_g	1.8683	2.0467	2.2882	1.8448	1.9713	2.0788	1.8449	1.8911	2.0971
R_g	1.0719	1.1895	1.3199	1.0670	1.1879	1.2932	1.0694	1.1133	1.3032
K	1.0541	1.1547	1.2910	1.0408	1.1122	1.1729	1.0408	1.0669	1.1831
K/R_g	**0.9834**	**0.9707**	**0.9781**	0.9755	0.9362	0.9069	0.9733	0.9584	0.9079
Tria(1,7,4), $\mu_0 = 4.000$									
μ_g	4.1163	4.3218	4.5777	4.1033	4.2793	4.4246	4.0971	4.1586	4.4275
R_g	1.0718	1.1892	1.3193	1.0670	1.1877	1.2929	1.0693	1.1131	1.3027
K	1.0291	1.0804	1.1444	1.0258	1.0698	1.1062	1.0243	1.0396	1.1069
K/R_g	0.9602	0.9086	0.8675	0.9614	0.9007	0.8556	0.9579	0.9340	0.8497
$U(1,7)$, $\mu_0 = 4.000$									
μ_g	4.1579	4.4285	4.7500	4.1428	4.3913	4.6000	4.1387	4.2265	4.6093
R_g	1.0718	1.1892	1.3193	1.0670	1.1877	1.2929	1.0693	1.1131	1.3027
K	1.0395	1.1071	1.1875	1.0357	1.0978	1.1500	1.0347	1.0566	1.1523
K/R_g	0.9699	0.9310	0.9001	0.9707	0.9243	0.8895	0.9676	0.9492	0.8846

In examining Table 7, note once again that the difference in the R_g values between the PH and DP distortions ($R_g \approx 1.19$) and the EX distortion ($R_g \approx 1.11$) at the "moderate" distortion level could be significant in the final selection of a distortion function at that level. In addition, note that decision maker objective (ii) could be answered just as easily as objective (i), but the original response surface study which facilitated the distortion parameter choices would have had to fix the distorted *expectations* rather than the *amount of density shift* being applied.

Table 7: Suggested distortions for selected distributions (via efficiency).

Risk Distribution	Low Distortion (0-10%)	Moderate Distortion (11-20%)	Heavy Distortion (21-30%)
Exp(3.5)	PH	PH	PH
Weibull(2,2)	PH	PH	PH
Tria(1,7,4)	DP	EX	PH
$U(1,7)$	DP	EX	PH

3.2 Some Distortion Selection Guidelines

In this subsection, we summarize some conclusions that can be drawn from our simple designed experiment regarding the selection of distortion functions and their associated parameters. It is important to note that these results are not generalizable to all risk scenarios, but illustrate the means by which one might make such selections in a specific scenario.

1. When an exponential or Weibull distribution is appropriate for the risk scenario, the PH distortion is drastically more efficient than the DP or EX. In the case of the exponential distribution, the PH also leaves the mode in place at zero, while other distortions "pull" the mode away from zero.

2. For the triangular and uniform distributions, no distortion appears to be as totally dominant (in efficiency) as the PH is for the exponential and Weibull. For each of these bounded distributions, the DP distortion is the most efficient in cases where only a small amount of distortion is required; questionably, the EX is more efficient in the vicinity of $R_g = 1.15$; and the PH is most efficient when larger amounts of distortion are required.

3. If higher moments are desired from the distorted distribution (e.g., the variance may well be of concern), then the DP and EX distortions may be preferred over the PH. Particularly in the case of the Weibull and triangular distributions, the DP builds up the area around the mean, likely reducing the impact on variance.

4. The parameter b of the DP distortion has a meaningful interpretation. In particular, it corresponds to the expected value of the worst outcome when b samples are taken from the random variable [12]. If the decision maker appreciates this interpretability but wishes to use either the PH or EX distortion, a value of b can be obtained which results in a DP match in μ_g to the specified a or c parameter. In this manner, the interpretability can be "loaned" to the PH and EX distortions through a single extra step.

In section 4, we illustrate the means by which distorted risk measures may be employed to incorporate the risk of capability shortfalls to in a resource allocation problem.

4   Resource Allocation and Distortion

Suppose there are nine distinct areas of military capability that are of interest to a decision maker. A shortfall in capability area i creates a risk (say X_i) with undistorted risk measure $E(X_i)$ and distorted risk measure $\hat{E}(X_i)$, $i = 1, 2, \ldots, 9$. However, to address shortfalls in capability (i.e., to mitigate risk), six distinct systems may be acquired. Let $m_{i,j}$ denote the percent shortfall mitigation to area i obtained from acquisition of system j, for $i = 1, 2, \ldots, 9$ and $j = 1, 2, \ldots, 6$. For instance, if $m_{i,j} = 0.50$, then the purchase of system j reduces the shortfall in capability area i by 50%. Let x_j, $j = 1, 2, \ldots, 6$, represent the proportion of resource j to be acquired. These values are the decision variables in the mathematical programming model. We assume the decision maker can choose to acquire

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some or all of a risk-mitigating capability so that $0 \leq x_j \leq 1$, $j = 1, 2, \ldots, 6$. Next, define c_j as the cost of acquiring one complete unit of resource j. The decision maker's objective is to maximize the risk mitigation by strategically choosing the proportion of various resources to purchase, subject to a fixed budget B. This may be achieved by solving the linear program (LP),

$$\text{Maximize} \quad \sum_{i=1}^{9} \sum_{j=1}^{6} \hat{E}(X_i)\, m_{i,j}\, x_j$$

$$\text{subject to} \quad \sum_{j=1}^{6} c_j\, x_j \leq B$$

$$x_j \in [0, 1], \quad j = 1, 2, \ldots, 6. \tag{15}$$

An intuitive explanation of the LP is as follows. Our decision maker would like to selectively apply distortion to the various risk distributions in order to better reflect his or her own risk priorities. For this reason, in the above formulation, we weight each $m_{i,j}$ by the distorted expectation risk measure, namely $\hat{E}(X_i)$, $i = 1, 2, \ldots, 9$. If we instead use the undistorted values, $E(X_i)$, $i = 1, 2, \ldots, 9$, this corresponds to solving the problem using only the information provided by subject matter experts (i.e., ignoring the decision maker's preferences). If we set $\hat{E}(X_i) = 1$ for each i in the above formulation, this is equivalent to ignoring the risks altogether. It is worth noting that Woodward [13], used an integer programming (IP) approach and a distorted expectation risk measure, but uniformly applied the DP distortion function with a constant parameter b across all capability areas. Our approach permits the decision maker to vary the type and level of distortion in each area.

We now illustrate solving the LP using a specific problem instance. We assume the budget is fixed at $B = 25$ monetary units. Suppose the decision maker is least risk averse in capability areas 8 and 9, somewhat risk averse in areas 4, 6, and 7, and most risk averse in areas 1, 2, 3, and 5. The weights summarized in Table 8 reflect the decision maker's degree of risk aversion in each area. In particular, a higher weight represents greater risk aversion. Also included are nine distributions assumed to originate from nine teams of subject matter experts. Specifically, these distributions correspond to the risk associated with shortfalls in the respective areas of military or homeland security capability.

Table 8: Notional data for illustrative example.

Area (i)	Weight	Distribution	$\mu_0 = E(X_i)$
1	20	Weib(3.5,3.3)	2.9692
2	30	Tria(0,4.67,3.2)	2.6233
3	19	$U(0,4)$	2.0000
4	13	Tria(0,4,2)	2.0000
5	46	Weib(2.04,1.74)	1.5416
6	6	Weib(3.08,2.84)	2.5391
7	6	$U(1,3)$	2.0000
8	0	Exp(0.45)	2.2222
9	0	Tria(0,1.875,0.5)	0.7917

We assume the decision maker would like to impose one of two priorities: (i) obtain the greatest possible increase in the expectation risk measure given a specified shift in density, or (ii) minimize the magnitude of density shifted to achieve a specified increase in the expectation. While either priority may be considered, we will proceed on the assumption that the decision maker prefers objective (i), and that the degree of risk aversion (i.e, the weights in Table 8) assigned to an area corresponds to a specific shift in density R_g. For instance, for Area 1, the risk distribution is assumed to be Weib(3.5,3.3), and the decision maker has chosen, based on available intelligence and projections, to shift 20% of the density beyond the median, or $R_g \approx 1.20$. At this level, using this distribution, the PH distortion is the most efficient. Setting $a = 0.735$ results in a distorted expectation of $\mu_g = 3.2422$. We continue in this fashion for all risk distributions, applying distortions based on the recommendations of Table 7. Table 9 summarizes the results of selectively distorting as per the pre-specified preferences of the decision maker. In this table, the column entitled, "Distortion" is the selected distortion function and its associated parameter value.

Table 9: Selection of distortion functions and parameters.

Area (i)	Distribution	R_g	Distortion	$\mu_g = \hat{E}(X_i)$
1	Weib(3.5,3.3)	1.20	PH, $a = 0.735$	3.2422
2	Rria(0,4.67,3.2)	1.30	PH, $a = 0.062$	3.0197
3	$U(0,4)$	1.19	EX, $c = 1.300$	2.2539
4	Tria(0,4,2)	1.13	EX, $c = 1.900$	2.1223
5	Weib(2.04,1.74)	1.46	PH, $a = 0.450$	2.2801
6	Weib(3.08,2.84)	1.06	PH, $a = 0.915$	2.6134
7	$U(1,3)$	1.06	DP, $b = 1.090$	2.0431
8	Exp(0.45)	1.00	N/A	2.2222
9	Tria(0,1.875,0.5)	1.00	N/A	0.7917

Table 10 summarizes the impact of each system on mitigating capability shortfalls. The table elements correspond to the percent shortfall mitigation that each potential acquisition addresses in all nine areas. For example, system 2 mitigates the risk of a shortfall in area 1 by 19%.

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Table 10: Percent shortfall mitigation.

Area (i)	$m_{i,1}$	$m_{i,2}$	$m_{i,3}$	$m_{i,4}$	$m_{i,5}$	$m_{i,6}$
1	0.00	0.19	0.00	0.26	0.26	0.00
2	0.46	0.21	0.00	0.12	0.00	0.00
3	0.34	0.19	0.00	0.05	0.00	0.23
4	0.14	0.42	0.00	0.36	0.00	0.05
5	0.10	0.21	0.92	0.30	0.00	0.10
6	0.00	0.00	0.54	0.00	0.00	0.11
7	0.16	0.00	0.00	0.00	0.25	0.00
8	0.19	0.00	0.00	0.00	0.31	0.48
9	0.00	0.00	0.00	0.00	0.33	0.36
c_j	7.0	7.0	10.0	8.0	8.0	9.0

The last row of Table 10 is the cost associated with the purchase of a *complete* system. Assuming a budget of 25 units, Table 11 summarizes the optimal solution to the resource allocation problem. The "Unweighted" solution assumes that we do not weight the mitigation terms by a risk measure at all. The rows entitled, "Weighted, Undistorted" and "Weighted, Distorted" provide the solutions using undistorted and distorted risk measures, respectively. In Table 11, an entry of 1.0 represents a recommendation to purchase a complete system, a decimal represents a partial purchase, and 0.0 represents no purchase.

Table 11: Optimal solutions under various scenarios.

Weighting Scheme	x_1	x_2	x_3	x_4	x_5	x_6
Unweighted	1.000	1.000	0.200	0.000	0.000	1.000
Weighted, Undistorted	1.000	1.000	0.300	1.000	0.000	0.000
Weighted, Distorted	1.000	1.000	1.000	0.125	0.000	0.000

The different optimal solutions for the three scenarios agree with intuition. In particular, we note that systems 1 and 2 are consistently chosen because they significantly mitigate the risk of shortfalls in capability areas 2-5 which the decision maker has deemed to be relatively important areas. On the contrary, systems 5 and 6 are seldom chosen due to the fact that they do not impact the critical areas (2-5) in a significant way. System 3 becomes an important asset once the decision maker's preferences are included because it has the potential to mitigate risks in a shortfall of capability area 5, the area in which the decision maker is most risk averse. In section 5, we provide some concluding remarks.

5 Conclusions

The properties of distortion functions have been well documented in the current risk analysis literature. However, the appropriate selection of a distortion function and its corresponding parameters is a problem that has not yet received much attention. This paper takes a small, initial step toward addressing this important issue. Our primary objective

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was to provide some practical recommendations for risk analysts who seek to use distortion functions to adjust the expectation risk measure to better account for low-likelihood yet potentially catastrophic events. For our purposes, we considered risks that may arise from shortfalls in military or homeland security capabilities which may result in obvious detrimental outcomes.

We have provided a procedure, via analytical and empirical methods, for the selection of distortion functions and their parameters on a set of common risk distributions. The use of distortion functions provides a tractable and documentable procedure to investigate the shifting of risk in the face of catastrophic events. Two new measures, efficiency and effectiveness, were proposed to distinguish the effects of different distortions and to make basic recommendations regarding the appropriateness of certain distortion functions and parameters using specific risk distributions. Additionally, a linear programming model was formulated to illustrate the means by which the distorted expectation risk measure can be used to influence the acquisitions plan of a risk-averse decision maker.

There are some obvious shortcomings in this work, and we note those here. First, the selection guidelines that we provide are limited to the risk distributions considered in this paper. Of course, it will be important to consider a wider range of distributions and to study the interaction between distribution and distortion function parameters. Moreover, we considered only the expectation risk measure, and it may prove useful to consider other coherent measures in the future. Another limitation stems from the use of the quantity R_g which measures only the magnitude of density shifted beyond the median of the undistorted risk distribution. This measure really does not tell us how "far" beyond the median the density has been translated. Other measures should be considered, as should a more comprehensive risk measure such as those described in [7]. It may also be instructive to investigate the relationship between the skewness of the risk distribution (perhaps using Pearson's skewness coefficient) and either the percent change in expectation or R_g. There appears to exist some correlation between Pearson's coefficient and the normalized mean. That is, it appears that certain distributions (the exponential is one case) provide more change in mean than others when distortion is applied. Finally, further research regarding the effects of distortion on variance may significantly impact the selection of distortion functions for specific risk scenarios.

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